United States Court of Appeals

for the Second Circuit

APPELLEE’S BRIEF

To be argued by
LEON LEIGHTON

74-2023

United States Court of Appeals
FOR THE SECOND CIRCUIT

SECURITIES & EXCHANGE COMMISSION,
Plaintiff-Appellee,

—against—

CAPITAL COUNSELLORS, INC., CAPITAL ADVISORS, INC., J. IRVING WEISS, ABRAHAM B. WEISS,
Defendants.

CONBOY, HEWITT, O'BRIEN & BOARDMAN,
Appellant,

SYDNEY B. WERTHEIMER,
Receiver-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF RECEIVER-APPELLEE

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POINT I—

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FOR THE SOUTHERN DISTRICT OF NEW YORK

BRIEF OF RECEIVER-APPELLEE

Preliminary Statement

Judge Cooper rendered the decision appealed from; it is reprinted at 65a-70a.* An integral part of his decision is his opinion appointing the equity receiver of defendant corporations. It is reported in 332 F. Supp. 291 (S.D.N.Y. 1971), and is reprinted at 3a-30a.

Questions Presented

This is an appeal from an order denying appellant-attorneys' petition for an allowance of $20,000, payable out of the receivership estate, for legal services rendered to defendant corporations in unsuccessfully opposing the application of the Securities and Exchange Commission for appointment of an equity receiver (68a-69a). The petition asks that such payment be granted a preferred status against the receivership assets (33a).

The questions presented for review are:

1. Did the District Court correctly apply to the facts of this case the reasoning of *Securities & Exchange Com'n* v. *Alan F. Hughes, Inc.,* 481 F.2d 401 (2d Cir. 1973), *cert. den.* 414 U.S. 1092 (1973)? An affirmative answer to this question would be dispositive of this appeal.

2. If the District Court had power to grant such allowance, was appellant's right thereto a matter addressed to the Court's sole discretion?

3. Did the District Court exercise its discretion in its denial of appellant's application?

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* References thus designated are to the Appendix.

Statement of the Case

A complete statement of the facts underlying the decision granting the equity receivership is necessary, in order to furnish the answers to Questions 1 and 3. It appears that appellant does not dispute that Question 2 should be answered in the affirmative (see Appellant's Brief, pp. 7, 10-11).

A. The District Court's Findings

The District Court granted the Commission's application for injunctive relief, and appointment of an equity receiver to administer the assets of defendant corporations, because "the Court found that defendants had committed the following fraudulent acts" (66a):

> "(a) Sale of unregistered securities in violation of the Securities Act §5(a) and (c), 15 U.S.C. §77e(a) and (c);
>
> "(b) Selling securities by means of untrue statements in violation of the Securities Act §17(a), 15 U.S.C. §77q(a); and
>
> "(c) Employing manipulative or deceptive devices in the sale of securities in violation of the Securities Exchange Act §10(b), 15 U.S.C. §78j(b) and Rule 17 CFR 240.10b5."

The basis of the §10(b) and §17(a) fraud was the Court's finding that "[d]efendants' widespread promotional literature and correspondence were replete with false and misleading statements omitting or concealing the substantial risks a participant undertook in subscribing to [defendants'] bond plan" (25a).

The basis of the §5(a) violation was that defendant corporations had flagrantly deviated in many significant respects from their representations to the Commission,[1] in reliance on which the Commission had issued a "no action" letter relieving defendants from registering under the Securities Act of 1933 (10a-25a).

As the result of the activities of defendant corporations, they marketed thirty-three syndicates, comprising over 600 public investors, controlling some seventy million dollars in treasury bills (9a). These customers *"have already suffered losses in excess of 4 million dollars"* (68a-69a).* Judge Cooper concluded (68a-69a, 69a-70a):

> "Clearly, public policy as enunciated in the *Hughes* case, 481 F.2d 401, is unalterable in its position that defendants, found to have committed the fraudulent acts aforementioned, shall not be permitted to impose the burden of defending themselves upon customers and other creditors who have already suffered losses in excess of 4 million dollars. That defendant's attorneys failed to provide for adequate assurance of compensation other than through reliance upon a successful defense of the action is no reason for transferring their loss to the public.
>
> * * * * *

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[1] These representations had been made by appellant as the attorneys for the corporations. It is not suggested that they were cognizant of the deviations when they occurred. But the investigation by the Commission, and the resulting complaint against which appellant defended, coupled with their long and intimate association with the corporate defendants prior thereto, clearly put appellant, "attorneys with extensive securities law expertise" (19a), on notice of these deviations before appellant performed the services for which compensation is sought herein.

* Unless otherwise noted, all italics are supplied.

"[W]e find that defendants' opposition to the SEC application in no way furthered the interests of their public investors. Although the professional services rendered were of high order and deserving of the legal fees requested, *the cost of the opposition interposed here cannot be paid out of the receivership estate.*"

B. The Operations of Defendant Corporations

Defendant Counsellors had been registered as a broker-dealer with the Commission since May 1960 (5a). Defendant Advisors, "the alter ego of Counsellors," had been registered as an investment advisor with the Commission since January 1962 (6a).

Individuals were solicited to invest $10,000 for a unit "participation" in a Government Bond Plan. Ten such investments were combined into a "syndicate" aggregating $100,000. Defendants then arranged to borrow an additional $900,000 from a bank for a two-year period. This $1,000,000 was used to purchase treasury bills, which were then pledged as security for the loan (7a-8a). The scheme was thus described by the District Court (8a-9a, footnote omitted):

> "Throughout this phase of the plan, each participant suffered a diminution of his equity as the loan's interest exceeded the profit realized from the treasury bill. As treasury bills matured, they were rolled over by defendants.
>
> "Weiss [defendants' president] predicted in his promotional literature and lectures that in the very near future interest rates would soar; this would create the proper market condition for defendants to advise the participants to transfer their holdings from treas-

ury bills to depressed long term low interest bearing government bonds. Despite the widespread unavailability of credit during this chaotic situation, the earlier margin purchase of treasury bills insured each participant access to $100,000 to subsidize the acquisition of long term bonds. Thus the purchase of treasury bills, even at a net loss to the participant, was an integral part of the bond plan. The newly acquired long term government bonds would be substituted for the treasury bills as collateral for the loan.

"Finally, Weiss had forecast a rapid retreat in interest rates which enhanced the value of the long term bonds. The participants were to realize substantial profits when the bonds would be sold after climbing in price in response to falling interest rates."

C. The §10(b) and §17(a) Fraud

The §10(b) and §17(a) fraud is fully described in the District Court's opinion at 25a-28a. The most significant details follow:*

> a. "Induced by claims of 3 to 1 profits, prospective investors were never alerted to the fact that defendants' projections as to fluctuation in interest rates and trading prices of government securities were speculative and subject to human error, that in fact such an error had occurred, and a miscalculation could endanger their entire investment. Although most participants were concerned with preserving assets, defendants failed to adequately explain the dangers inherent in purchasing on margin" (25a-26a).

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* Transcript and exhibit references in the opinion have been omitted.

b. "Over the past years, defendants' solicitation and correspondence foretold that the switch from bills to bonds was imminent. However, defendants failed to disclose to investors that they had been predicating this occurrence over a substantial period of time" (26a).

c. "During the tight money market in January and February 1970, three syndicates were closed because defendants were unsuccessful in replacing expiring loans. Despite the critical feature of the leverage provided by these loans to the overall success of the bond plan, the affected investors were not immediately notified, and subsequent investors were never informed of, this episode or its potential reoccurrence" (27a).

d. "Defendants did disclose that while awaiting the purchase of long term bonds the interest differential would result in a net loss during the initial stage in the plan. . . . Although Weiss told investors that he did not expect the differential to rise above 2%, undisclosed to subscribers was the fact that bill yields were steadily declining to less than 4% as interest rates of over 9% were required on loans in force. Under this circumstance, the annual cost of a participation would reach nearly 50% of the individual's investment" (26a-27a).

e. "Defendants' promotional 'literature' by reciting that the investor 'retains final control of the buy and sell decisions because you own the securities' misled investors into believing that they retained the option of withdrawing from the program" (26a).

f. "Subscribers were led to believe that their $10,000 investment would complete their obligation for a unit participation in the bond plan. Defendant never ad-

vised investors that under the terms of some loan agreements, the margin requirement would be increased as bonds were substituted as collateral. If the investor were unable to supply these additional funds, he endangered the costly liquidity position he maintained during the first phase of the bond plan" (27a).

Judge Cooper concluded (29a):

> "In the course of this sale of securities defendants: (a) failed to truthfully inform investors of the true costs and substantial risks of the Government Bond Plan, *S. E. C.* v. *Van Horn,* 371 F.2d 181 (7th Cir. 1966); *Hughes* v. *S. E. C.,* 174 F.2d 969 (D.C. Cir. 1949), (b) failed to deal fairly and honestly with their customers in the operation of the Government Bond Plan."

D. The §5(a) Violation

The Commission contended that participation in the Government Bond Plan constituted a security as defined by Section 2(1) of the 1933 Act, 15 U.S.C. §77(b)(1), and that accordingly defendants had violated §5(a) by their failure to register. Defendant corporations defended on the basis of a "no action" letter of November 17, 1967, issued by the Commission's staff after reviewing with defendants' attorneys (appellant here) the necessity for registration of the Plan (9a-10a).

The District Court found that the "no action" letter had been procured in reliance on the following representations, from which defendants consistently deviated:

> a. "... [T]he program is designed for sophisticated and wealthy investors able to invest in multiples of $10,000" (10a-13a);

b. Investors would have "the power to control the purchase and sale of the U. S. Government securities in the escrow account and thus the sole responsibility for management decision" (13a-19a).

c. The participant would have "sole discretion to buy and sell the securities pledged on that portion taken by him" (19a-20a).

Defendants also misrepresented by characterizing the Government Bond Plan as equivalent to an ordinary broker's account, as distinguished from what traditionally would be considered as constituting a security (21a-25a).

Judge Cooper concluded (29a):

> "In the offer and sale of the Government Bond Plan: (a) persons invested money in a common enterprise and were led to expect profits solely from the efforts of the defendants, (b) persons invested in it because of economic inducements, (c) defendants provided management services, (d) the economic welfare of investors was inextricably woven with the ability of defendants to carry out this common enterprise for the benefit of those whose investments were solicited."

E. Appellant's Professional Services on Behalf of Defendant Corporations

Appellant had organized defendant corporations shortly after 1960, and from that time on represented them pursuant to a monthly retainer (57a-58a). They prepared and submitted to the Commission the letters containing the representations, in reliance on which the Commission issued the "no action" letter. Appellant's letters are printed in the Exhibit Volume herein.

In April 1970, appellant cooperated with the Commission in making an audit of defendants' books. In December 1970, appellant was retained by defendants to represent them in the investigation of their affairs to be conducted by the Commission (58a-59a).

Prior to March 27, 1971, when the temporary injunction was signed, appellant devoted 59¾ hours to legal services for defendants (63a). Subsequent to that date, and after the corporations had been partially taken into *custodia legis* (4a-5a), appellant devoted 359½ hours to the unsuccessful opposition to the Commission's application for appointment of a receiver (see Schedule A, following 38a).

On April 2, 1971, Judge Cooper entered an order providing that:

> "the corporate defendants may retain such employees as they deem necessary for office and other expenses provided that all expenses so incurred shall be paid for in full by the corporate defendants and shall in no way impair any funds owing to any public customers. All expenses herein shall be indemnified by deposits in the Indemnity Fund by the individual defendants J. Irving Weiss and Abraham B. Weiss" (48a).

This indemnification provision specifically included attorneys' fees (47a). This order was agreed to and signed by appellant (*ibid.*), who, according to the Commission's attorney, "helped establish the '*Modus Operandi*,' the central feature of [which] was that the individual defendants, not the corporate defendants, were to bear the costs of continued operations, including accounting and legal fees" (47a). Appellant often argued the point that the Weisses were "personally bearing the cost of the litigation" (49a).

This order was supplemented by a similar order of the District Court dated May 7, 1971 (48a). Neither order provided for the retention of counsel by the corporate defendants for the purpose of defending the corporate defendants against the appointment of a receiver (*ibid.*).

POINT I

The District Court correctly applied to the facts of this case the reasoning of *Securities & Exchange Com'n* v. *Alan F. Hughes, Inc.*, 481 F.2d 401 (2d Cir. 1973), cert. den. 414 U.S. 1092 (1973).

A

In *Securities and Exchange Com'n* v. *Alan F. Hughes, Inc.*, 461 F.2d 974 (2d Cir. 1972), this Court affirmed the order of Chief Judge Foley, adjudicating that the customers of Hughes were in need of the protection afforded by the SIPC 1970 Act and appointing a trustee for the liquidation of the broker-dealer. "The application by SIPC was hotly contested both in the district court and on appeal to this court on a number of grounds. The decision of this court . . . was the first to interpret the 1970 Act in a number of important respects." *Securities & Exchange Com'n* v. *Alan F. Hughes, Inc.*, 481 F.2d 401, 402 (2d Cir. 1973), cert. den., 414 U.S. 1092 (1973).

Counsel for Hughes then filed a petition, claiming "that for their services in resisting the SIPC applications they are entitled to attorney's fees [of approximately $7,000], as a matter of first priority from the estate of Hughes, Inc. or from SIPC funds, or from both" (*ibid.*). This Court affirmed the denial of the petition on two grounds.

First, resistance to the appointment of a trustee is not one of the "purposes" of the liquidation proceeding, and therefore is not authorized by subsection 6(f)(2) of the 1970 SIPC Act. 15 U.S.C. §78fff(f)(2) (pp. 402-403). Second, "[w]e have long held that legal services in resisting a bankruptcy petition are not compensable under that Act"; "the analogy to the Bankruptcy Act is compelling" (pp. 403-405).

Judge Cooper recognized that the *Hughes* case was decided on the foregoing grounds. But he concluded that the reasoning of that case applied with equal force to the facts at bar. He said (pp. 68a, 69a):

> "Though the *Hughes* case involved an interpretation of the 1970 Act, *its reasoning is equally applicable to the instant proceeding.* If legal services rendered in opposition to a bankruptcy proceeding are not compensable out of the bankrupt estate, then clearly the services rendered herein in opposition to the SEC application for injunctive relief and receivership are also not compensable from the assets of Counsellors and Advisors.
>
> "Bankruptcy may result from ineptitude or misfortune without any imputation of fraud. Here the receivership was imposed not only because defendants were failing to meet their customer obligations *but also because that failure resulted from fraudulent acts perpetrated by defendants in violation of the Securities Act and the Securities Exchange Act.* See *SEC* v. *Capital Counsellors, Inc., supra* [3a-30a].
>
> "The purpose of these Acts was to achieve a high standard of business ethics in the securities industry

and prevent fraud in the purchase and sale of securities so as to protect the public investor and minimize his losses. *SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963); *Zeller* v. *Bogue Elec. Mfg. Corp.*, 476 F.2d 795 (2d Cir. 1973). The intendment of the 1970 Act was similarly to protect customers or broker-dealers who had fallen into financial difficulty and incapable of meeting their customer obligations; imputation of fraud to the broker-dealer is unnecesary. See *SEC* v. *Alan F. Hughes, Inc.*, 461 F.2d 974 (2d Cir. 1972); *Lohf* v. *Casey*, 350 F. Supp. 356 (D. Colo. 1971)."

* * * * *

"The Acts which defendants were found to have violated provide for payment of attorneys fees in certain instances. . . .

"The underlying rationale of these cases, as we interpret them, is that where prosecution or defense of an action under the federal securities laws has been in furtherance of the purpose of those laws—protection of the public investor—then the parties bearing the costs of such prosecution or defense are entitled to reimbursement. See *Mills* v. *Electric Auto-Lite, supra* [396 U.S., at pp. 390-397];* *Smolowe* v. *Delende Corp.*, 136 F.2d 231 (2d Cir. 1943). Applying that reasoning to the instant proceeding, we find that defendants' opposition to the SEC application in no way furthered the interests of their public investors."

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* Through an obvious typographical error, the opinion refers to page 241 of *Mills*. The discussion of legal fees in that case appears at pp. 390-397.

B

Appellant bases its case on *Barnes* v. *Newcomb,* 89 N.Y. 108 (1882), and its progeny. These cases involved actions by the New York Attorney General for equity receiverships of insurance companies on the ground of their insolvency, pursuant to Chapter 902 of the Laws of 1869.

The reasoning of *Hughes,* as applied by the District Court here, is entirely consistent with those cases. It is clear from their reasoning that attorneys should not be compensated for resisting a receivership where any one of three situations exists, all of which are present in the case at bar:

> (a) The corporation's officers "had resorted to fraudulent statements and devices in order to enable it to continue its business and maintain the confidence of" the participants in the bond syndicates;
>
> (b) The issue is not the debatable one of solvency, but rather whether a defendant corporation had perpetrated frauds and other violations of the securities legislation, which is not a debatable question.
>
> (c) The corporation did not owe a fiduciary obligation to those whom it has defrauded to regain possession of the funds entrusted to it.

The first reason is vividly demonstrated by both the holding and the reasoning of *People* v. *Commercial Alliance L. Ins. Co.,* 148 N.Y. 563 (1896). In that case, Special Term awarded an allowance to the attorneys. General Term reversed. In affirming General Term, the Court said, per Andrews, Ch. J. (pp. 564-565, 565-566):

> "The case of *Barnes* v. *Newcomb* (89 N.Y. 108) is an authority for the proposition that a court of primary

jurisdiction in the exercise of its discretion may authorize the receiver of an insolvent corporation, appointed in an action brought for its dissolution, which was defended in good faith by the corporation, though unsuccessfully, to pay as a preferred claim out of the fund in his hands, a reasonable sum for the compensation of counsel employed by the corporation in defending the action. The principle upon which an allowance in such case may be made is that counsel fees are in the nature of expenses incurred by the corporation and its trustees in the protection and preservation of the trust which they represent, and even if it turns out that a case is made for the interference of the state, so long as the defense was made in good faith and upon reasonable grounds, there is apparent justice in subjecting the property and fund involved in the litigation to expenses incurred in discharging a general duty cast upon the corporation and its trustees, to take all reasonable means for its protection. (*Atty.-Genl.* v. *North American Life Ins. Co.*, 91 N.Y. 57.)

* * * * *

"In the present case it appears and it is admitted that the counsel employed by the corporation acted in good faith, and defended the action, believing that the company was solvent, and stopped the defense when they discovered that they had been misinformed.[2]

"But both the Special and General Terms substantially found that the corporation and its officers knew before and when the action was commenced that the

[2] If it were necessary to establish that fact, we submit that the record herein would mandate the finding that appellant should have known that defendant corporations did not have a good defense to the Commission's action (p. 9, *supra*).

company was insolvent, *and it appeared that its officers had resorted to fraudulent statements and devices in order to enable it to continue its business and maintain the confidence of policyholders.*

"In our opinion it would be contrary both to equity and to sound public policy to permit counsel fees out of the fund to be awarded to the applicant on the theory that counsel do not hold their rights under the corporation which employs them, but independently of the corporation, *or that they can assert a right unaffected by the fraud or bad faith of the corporation in interposing a defense.* There is little danger that this rule will disable corporations assailed from securing in proper cases the services of competent counsel. If any embarrassment arises it will be in cases of dishonest attempts to keep corporations afoot to the prejudice of honest dealing. If it tends to this result the public will suffer no harm.

"Our conclusion is that the General Term properly reversed the order of the Special Term, assuming, as is claimed by the appellants, that the reversal proceeded on the ground that upon the facts proved and found there was no discretion in the court to grant the application."

See also opinion of Van Brunt, P.J., at General Term, 91 Hun 389 (1st Dept. 1895).

That reasoning is directly applicable to the case at bar. Judge Cooper specifically found that "[h]ere the receivership was imposed not only because defendants were failing to meet their customer obligations but also because that failure resulted from fraudulent acts perpetrated by

defendants in violation of the Securities Act and the Securities Exchange Act" (p. 12, *supra*).

The second reason is demonstrated by a more detailed analysis of *Barnes* v. *Newcomb, supra* (89 N.Y. 108). On the first trial, Special Term awarded $10,800 (Plaintiff's Brief in 89 N.Y., p. 2). This covered services both prior to the appointment of the receiver and "three separate proceedings growing out of the appointment of [the receiver], all of which were bitterly and stubbornly resisted and opposed, and in none of them was there a cessation of legal warfare until the court of last resort had been appealed to." *Barnes* v. *Atlantic Mutual Life Insurance Company,* 59 How Pr. 239, 245 (1880). General Term reversed, on the ground that plaintiff had no right of action against the receiver for services subsequent to his appointment, since they were not retained by the receiver. *Barnes* v. *Newcomb,* 24 Hun 142 (3d Dept. 1881), not reported in full; for abstract of opinions, see Plaintiff's Brief in 89 N.Y., pp. 16-19).

On the second trial, Special Term awarded plaintiff $500, which was affirmed at General Term (not reported) (Plaintiff's Brief, *supra,* at 2-3). This was affirmed in 89 N.Y., where the Court said, per Rapallo, J. (pp. 113, 115-116):

> "We are of opinion that for the services rendered by the plaintiff to the corporation after the appointment of the receiver, an action against the receiver cannot be maintained. The company, or its officers, could not after that date subject the fund in the hands of the receiver to any legal liability. For its indebtedness to the plaintiff, incurred before the appointment of

the receiver, the plaintiff has been permitted to recover."[3]

* * * * *

"The trial court, however, found that the opposition on the part of the company to the appointment of a receiver was in good faith and with a conviction of the solvency of the company, and its right to conduct its own business, *and that it had probable cause and reasonable ground for such opposition.* Under such circumstances it was clearly the duty of the officers of the company, as trustees for all parties interested therein, to take the necessary steps to protect its corporate existence, and to repel the attack which they regarded as unfounded, and it is but just that such reasonable expenses as they incurred for those purposes should in some form be allowed to them. * * *

"As a general principle, trustees of a corporation whose corporate existence is attacked, should be afforded the means of resisting such attack, so far as the facts justify and their duty demands. *Public policy requires that they should be protected to this extent, but no farther, and a premium should not be held out for captious and vexatious contests at the expense of the*

[3] While the receiver here was not appointed until June 11, 1971, the District Court signed a comprehensive temporary restraining order on March 25th (4a); and an order requiring defendants to pay the cost of the litigation was signed on April 2nd, contemporaneously with the appointment of a fiscal agent of defendant corporations (47a-49a). These orders effectively precluded defendant corporations from authorizing legal services to be charged against the funds in *custodia legis.* Even under the holding in *Barnes,* appellant could not claim compensation for the 359½ hours of services after March 25th (p. 10, *supra*). However, the Receiver takes the position that even services prior to March 25th are not compensable, for the reasons stated in the text.

fund, which the court is under the highest obligation to preserve, as far as possible, to meet the just debts and liabilities of the corporation."

The situation there was diametrically contrary to that in the case at bar. In *Barnes*, where the issue was solvency, it was a debatable question as to whether the defendant corporation should be interfered with by the Court. As Special Term said (59 How. Pr., *supra*, at 248-249):

> "I have already recited the history of the proceedings taken by the company, and the further fact that all these proceedings were taken in good faith by the company and its counsel, and in the honest and conscientious belief of its solvency and ability to manage its affairs without the intervention of the court. Believing this, what was the duty of the company? Was it to submit passively? Would it have been justified in allowing its management and operations to be taken from it without resistance and its corporate existence wiped out? I think not. Indeed, the company was partially successful in the court of appeals on the appeal from the order of the general term affirming the special term order appointing a receiver. The court of appeals modified that order so 'as not to dissolve the corporation, and so as not to give the securities deposited with the superintendent of the insurance department to the receiver.' The fact that the court refused to appoint a receiver in the first instance on the papers presented but waited for other and further proof and to give an opportunity to make up the comparatively small deficit as claimed by the attorney-general; the modification of that order when made by the court of appeals; the fact that the attor-

ney-general united in the appeal from the order subsequently made denying motion to discharge the receiver and to restore the company its property and assets so that it might continue its business, all tend to show that the affairs of this company were in a situation entirely different from many, perhaps from any other that has been given over to a receiver, *and that it was a debatable question, to say the least, as to whether it should be interfered with by the court.* Undoubtedly its (the court's) action was proper and right, but the right was not so clear as to make resistance thereto by the company unreasonable or open to the suspicion that its action was not taken all through in good faith, with fair grounds to hope for success. Under such circumstances I think the managers and officers of the company not only had the right but that it was their duty to do what they could to keep it in life."

This finding of the Trial Court was relied on by the Court of Appeals (p. 18, *supra*). But in the case at bar, it was not a debatable question as to whether defendant corporations had perpetrated frauds, in violation of §10(b) and of §17(a) of the Securities Act (pp. 6-8, *supra*); and had sold unregistered securities in violation of §5(a) of the Securities Exchange Act (pp. 8-9, *supra*).

Other cases applying *Barnes,* and relied on by appellant, are based on the same rationale.

Thus, in *Godley* v. *Crandall & Godley Co.,* 181 App. Div. 75 (1st Dept. 1917),* the Court refused to direct repayment of compensation paid to counsel in a stockholders' representative action for resisting the appointment of a

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* Modified on other points, 197 N.Y. 579 (1910).

receiver of all of the assets of a stock corporation. The Court said, per Scott, J. (p. 78):

> "This resistance was justified in the event because the Court of Appeals very materially restricted the scope of the receivership, . . . * * * In such a case the directors may properly employ and pay counsel in behalf of the corporation, assuming the burden, if the expenditure is questioned, of showing that some interest of the corporation was in fact threatened and that, for that reason, the expenditure was justified, and upon the question of justification the judgment of the directors as to the necessity for the expenditure, *if exercised honestly and in good faith,* is not open to question in an action which is predicated not upon errors of judgment, but upon allegations of bad faith and dishonesty. To appoint a receiver of all the assets of a corporation is ordinarily a serious matter, and the directors are not to be charged with wastefulness merely because they resisted such a receivership. (*Barnes* v. *Newcomb,* 89 N.Y. 108; *People* v. *Commercial Alliance Life Ins. Co.,* 148 id. 563.)"

See, to the same effect, *Matter of Importers, &c., Exchange,* 14 Daly 419 (1889); *Matter of Beha (Second Russian Insurance Co.),* 136 Misc. 715 (Sup. Ct. 1930).

The third reason why *Barnes* does not apply to the case at bar is found in *Matter of Attorney General* v. *North American Life Insurance Co.,* 91 N.Y. 57 (1883). That was decided eight months after *Barnes,* and six of the seven Judges had participated in *Barnes.*

That was also a case where an equity receiver was appointed for an insurance company on the ground of its

insolvency. As a result of the objections of intervening policy holders to the receiver's account, his compensation was substantially reduced.

In denying any allowance to counsel for these intervenors, the Court said, per Finch, J. (pp. 61-62):

> "The most familiar illustrations of that sort of allowance are found in cases where suits are brought and defended by trustees, or persons acting *en autre droit.* The principle upon which counsel fees are granted in such instances is that of a necessary disbursement, and it stands upon the same ground as any other necessary expense of the preservation of the fund. * * *
>
> "Much of the largest proportion of the cases cited on behalf of the appellants fall within the principle of allowances to trustees. Many of them respect counsel fees awarded to executors, administrators and guardians; to assignees and committees of lunatics; and lately we have further applied the principle to the case of a corporation defending itself and the funds intrusted to its care against an attack upon its corporate life made at the suit of the attorney-general. (*Barnes* v. *Newcomb,* 89 N.Y. 108.) *Its defense was the defense of a trustee, seeking in good faith to regain possession of its trust funds, and preserve its corporate life for the performance of its trust duties.*"

Defendant corporations here have caused the participants in their bond plan to lose in excess of $4 million dollars (a) by obtaining their money by means of false representations; and (b) by selling securities for which they

avoided registration through a "no action" letter issued in reliance on assurances from which they consistently deviated. It can hardly be urged that their resistance to bringing the remaining trust funds under the protective arm of the District Court "was the defense of a trustee, seeking in good faith to regain possession of its trust funds, and preserve its corporate life for the performance of its trust duties."

Robinson v. Mutual Reserve Life Ins. Co., 162 Fed. 794 (S.D.N.Y. 1908), was a diversity action for the appointment of equity receivers of defendant, on the ground of insolvency. Ten months after the bill was filed (see Record on Appeal in 189 Fed. 347, fol. 292), the company filed answers admitting insolvency, and joining in the prayers of the bill (162 Fed., at 795). Attorneys who had opposed the appointment during that period filed a claim for a "discretionary" preference for compensation, under the authority and reasoning of the decision in *Barnes* (Record, *supra*, fols. 289-294).

Circuit Judge Ward said (175 Fed. 624, 627 [1909]):

> "As to claims for preference in favor of services of attorneys in resisting the attempt to declare the Company to be insolvent, there may be a discretion. (*Barnes* v. *Newcomb*, 89 N.Y. 108; *People of New York* v. *Commercial Ins. Co.*, 148 N.Y. 563), which is left for the consideration of the special master as to each claim presented to him."

The Special Master then made allowances "to be paid by the Receivers in full, out of the general assets" (Record, *supra*, fols. 289-301). Judge Ward overruled the exception to these "preferential awards" "on the strength of *Barnes* v.

Newcomb, 89 N.Y. 108, approved in *Matter of Attorney General* v. *North American Life Ins. Co.,* 91 N.Y. 62." 182 Fed. 850, 856 (S.D.N.Y. 1910).[4] It is significant that Judge Ward adopted the interpretation of *Barnes* in *Commercial Insurance* and in *North American.*

C

The Receiver originally took the position that appellant was entitled to have an allowance paid out of corporate funds (60a-61a, quoted in Appellant's Brief, p. 5). The Receiver's affidavit was dated December 14, 1971 (61a), prior to the decision in *Hughes.*

The Receiver interpreted *Barnes* and *Robinson* as supporting that principle. The decision in *Hughes* led the Receiver to the conclusion that public policy opposes payment of allowances to attorneys for opposing an equity receivership under circumstances such as those in the case at bar.

Appellant argues that the cases cited by the District Court "do not deal with the liability of defendant or defendant's own assets for services incurred by contract" (p. 11). This overlooks the essential fact that the liability here is sought to be imposed on assets which are no longer the property of defendants, but of the defrauded persons for whose benefit the Receiver was appointed.

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[4] Judge Ward's order was affirmed in 189 Fed. 347 (2d Cir. 1911), but examination of the record and briefs indicates that this exception was not pressed on appeal.

POINT II

If the District Court had power to grant such allowance, was appellant's right thereto a matter addressed to the Court's sole discretion?

It appears that appellant does not question the proposition that, if the District Court had power to grant the allowance requested, it was a matter addressed to the Court's sole discretion. See Conclusion to Appellant's Brief, pp. 11. In any event, this is the clear holding of the cases relied on by appellant. *Barnes, supra,* 89 N.Y., at 115;[5] *Commercial Alliance, supra,* 148 N.Y., at 565.[6]

POINT III

The District Court did exercise its discretion in its denial of appellant's application.

It is clear from Judge Cooper's opinion that he denied appellant's application, not because of any assumed lack of power, but because, exercising the discretion which he knew he had, he concluded that the payment of monies out of the receivership estate was not warranted under the public policy enunciated in *Hughes* (pp. 4-5, 12-13, *supra*). Having tried the action which resulted in the

---

[5] "But it was entirely in the discretion of the court, in administering the fund, to determine up to what stage in the proceeding the opposition was proper, and what would be a reasonable sum to be allowed for the services rendered, or whether any allowance should be made."

[6] "But in any such case it is in the discretion of the court, in view of all the circumstances, to determine whether any or what allowance shall be made."

equity receivership, he was fully familiar with the circumstances under which appellant's services were rendered, and whether they satisfied that public policy.

He reiterated his ultimate findings "that defendants had committed the following fraudulent acts" (66a):

> "(a) Sale of unregistered securities in violation of the Securities Act §5(a) and (c)";
>
> "(b) Selling securities by means of untrue statements in violation of the Securities Act §17(a)";
>
> "(c) Employing manipulative or deceptive devices in the sale of securities in violation of the Securities Exchange Act §10(b)."

This reiteration indicates that he was giving consideration to the mediate data detailed at pp. 6-9, *supra,* which support these ultimate findings.

He concluded (65a):

> "After careful consideration of movant's claim *and of the nature and purpose of the underlying action,* we conclude that such fees are not payable out of the assets of the receivership estate. Accordingly, the motion is denied in all respects."

Appellant's brief states (p. 6): "Presumably, the receiver has recognized all other contract claims of the debtor incurred before the receivership." The Receiver has not recognized any such claims as having *preferred* status against the receivership assets, which is what appellant seeks.

The Court has directed that 95½% of the receivership assets constitute a trust fund to be paid out to the de-

frauded syndicate participants. Recognizing appellant's claim to a preferred status would delete this trust fund to that extent.

Further, the Receiver has not recognized any contract claims for services performed subsequent to March 25, 1971, when the Court took the entire estate into *custodia legis* by appointing a fiscal agent, and entered the orders requiring the individual defendants to indemnify the customers of the corporations against any expenses of operation (4a-5a, 47a-49a). This was equivalent to a temporary receivership, except that those words were not used, in order not to make the participants unduly apprehensive.

Randolph v. *Scruggs,* 190 U.S. 533 (1903), involved an assignment for the benefit of creditors, followed by a petition in bankruptcy within four months. The court held services of an attorney rendered to the voluntary assignee "may be allowed so far as they benefited the estate . . . and may be preferred to that extent. No ground appears for allowing the item for services in resisting an adjudication of bankruptcy" (p. 539). In *Conrad* v. *Pender,* 289 U.S. 472 (1933), the Court held that, under §64b(3) of the Bankruptcy Act, an allowance could be made out of the bankrupt estate for services "rendered in aid of the administration of the estate and the carrying out of the provisions of the Act" (p. 476). This principle, that legal services could be compensated for out of the bankruptcy estate only for benefits rendered to the estate, was reiterated by this Court in *In re Jack Stolkin, Inc.,* 42 F.2d 829, 831 (2d Cir. 1930); and by the Sixth Circuit in the recent case of *In re Armstrong Glass Co., Inc.,* CCH Bankruptcy Law Reports, ¶65,387 (Aug.

29, 1974, not yet officially reported). See, to the same effect, *Fine* v. *Weinberg*, 384 F.2d 471, 473 (4th Cir. 1967); *Bass* v. *Quittner, Stutman & Treister*, 381 F.2d 54, 57 (9th Cir. 1967); *Cle-Ware Industries, Inc.* v. *Sokolsky*, 493 F.2d 863, 868 (6th Cir. 1974).

In the present case, Judge Cooper found that appellants have not shown any benefit to the receivership estate from any of the services for which compensation is sought (69a). He was aware that the payment sought a preferred status against the receivership estate (33a). He applied the analogy of the bankruptcy cases (67a-69a), as this Court did in *Hughes*, by denying the motion in all respects (65a). He thus exercised his discretion by holding that in no event was the claim entitled to a preferred status; and that no ground appeared for allowing the item even on a non-preferred basis.

Conclusion

For all of the foregoing reasons, it is submitted that the order of the District Court should be affirmed.

Respectfully submitted,

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as Receiver-Appellee

Service of three (3) copies of the within Brief
is admitted this 7th day of November 1974

D. Deutsch
Appellant

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